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HQ SOUTHCOM ALSO FOR POLAD
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TAGS: ECON EFIN EPET EINV PGOV VE
SUBJECT: VENEZUELA'S ECONOMY IN 2008: A DIFFICULT YEAR AS
VULNERABILITIES MOUNT

REF: A. CARACAS 25

¶B. 2007 CARACAS 2403
¶C. 2007 CARACAS 2381
¶D. 2007 CARACAS 2380
¶E. 2007 CARACAS 2362
¶F. 2007 CARACAS 2346
¶G. 2007 CARACAS 2330
¶H. 2007 CARACAS 2176
¶I. 2007 CARACAS 2013
¶J. 2007 CARACAS 1003
¶K. 2007 CARACAS 332

Classified By: Economic Counselor Andrew N. Bowen for reasons 1.4 (b) a
nd (d).

¶1. (C) Summary: 2008 is likely to be a difficult year for Venezuela economically due to continued inflation, shortages, and policy-induced distortions. Nonetheless, the BRV's relatively strong external and fiscal positions, buoyed by record crude prices, should allow it to weather these problems, albeit with increasing difficulty. In the medium term (1 - 3 years), Post continues to believe that problems inherent in the BRV's statist-populist economic model will lead to economic turmoil/crisis unless the BRV changes direction. Underlying problems include declining oil production; a lack of private investment; massive government spending; an overvalued exchange rate, and an import-dependent consumption bubble facilitated by rapid credit expansion. Three key unknowns are the price of oil, prospects for increased oil production, and BRV policy decisions, all of which significantly impact Venezuela's near-term economic future. Given the political and economic trade-offs involved, we do not believe President Chavez will make the difficult policy adjustments that would turn an eventual hard landing into a somewhat softer one. End summary.

¶2. (C) In May 2007 post argued that the Venezuelan economy was vulnerable in the subsequent 12 to 30 months due to

economic distortions that would eventually lead to turmoil/crisis (ref J). This message reviews these vulnerabilities based on conversations with economic contacts and on recent developments, including an unprecedented spike in oil prices from already high levels and the defeat of President Chavez' proposed constitutional reforms in the December 2 referendum.

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2008: More Inflation, Plasma TVs, and No Milk?
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¶3. (C) 2007 was a year of inflation, shortages, and policy-induced economic distortions, fueled by massive government spending and negative real interest rates against a backdrop of currency and price controls. We expect these problems to worsen in 2008 unless the BRV changes its economic policies.

¶4. (C) According to the Central Bank of Venezuela (BCV), CPI inflation in 2007 was 22.5 percent and core inflation, which excludes many price-controlled items, measured 28 percent. Venezuela's inflation is largely a result of high government spending (fueled by the oil windfall), foreign exchange controls, and negative real interest rates, all of which have contributed to rising liquidity and booming consumer demand. (Note: Liquidity (M2) grew by 31 percent in 2007 and 66 percent in 2006. End note.) In 2007 the BRV undertook various measures to contain inflation (ref K), but these measures were piecemeal and largely ineffective. Particularly given Chavez' need to spend in advance of fall 2008 nationwide elections for mayors and governors, most local analysts expect inflation to increase in 2008: banking sector, academic, and economic consulting contacts predict

CPI inflation somewhere between 22 and 35 percent.

¶5. (C) Despite a boom in imports of luxury goods, rolling shortages of staple goods, which are expected to worsen in 2008, are a fact of life in Venezuela (ref C). Strict price controls on more than 400 items, combined with increases in world prices and domestic consumption, caused intermittent shortages of products such as milk, black beans, eggs, cooking oil, sugar, flour, meat, rice, and toilet paper in ¶2007. Many local producers have shifted production to goods without price controls, a distortion that has further aggravated the shortages. This situation will worsen in 2008 unless the BRV relaxes or lifts the price controls. Recent statements by BRV officials indicate that they are contemplating lifting some controls - which, of course, would have an inflationary impact. What is clear is that policy options are narrowing for the BRV. While inflation and shortages may be two sides of the same coin, it seems to us that Chavez will have to choose one over the other. Our sense is that shortages carry a stronger political cost, and that if the BRV loosens price controls it will try to mitigate the inflationary effect with tighter monetary policy which carries its own set of costs.

¶6. (C) Price controls are just one of many causes of distortion in an economy where the state is playing an increasingly large role. Other significant distortions result from foreign exchange controls, an overvalued official exchange rate, obligatory bank lending requirements, rigid labor laws, new taxes, direct state ownership of companies in "strategic sectors," and a host of other factors. The growing breadth of state involvement and intervention in the economy, in addition to creating ample opportunities for arbitrage and corruption, is straining management capacity in the BRV and the private sector.

¶7. (C) Two key BRV institutions showing obvious signs of strain are the Commission for the Administration of Foreign Exchange (CADIVI) and PDVSA. CADIVI is overwhelmed with requests for hard currency, a situation which may lead to increasing bottlenecks in the import process (ref G). PDVSA has been weakened by a loss of technical and management expertise and growing "mission creep" into areas such as

social spending and potentially food production and distribution. Our clear sense is that PDVSA is currently experiencing significant cash flow problems (ref F and septel). If the BRV seeks to increase its control over the economy, 2008 will bring about further distortions and disruptions.

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BRV Resources Sufficient to Keep Problems in Check
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¶8. (C) Despite these anticipated difficulties, we believe that the BRV has sufficient fiscal resource to prevent an economic crisis in 2008. The record oil windfall over the past four years and associated strong economic growth (10.3 percent in 2005 and 2006, and 8.3 percent in 2007) have allowed the BRV to build up an array of dollar and local currency assets including BCV reserves (currently at USD 33 billion), BRV deposits in the banking sector and BCV, and funds controlled by parastatal institutions such as FONDEN, Bandes, and the Banco del Tesoro. Lack of transparency and/or reliability of official data make the precise value and liquidity of these assets difficult to divine; current estimates for ther value run between USD 70 and 90 billion (incluing reserves and calculating the bolivar-denominatd assets in dollars at the official exchange rate). The BRV will continue to use these resources in 2008 to mitigate economic problems, for example making cash transfers that help the poor maintain purchasing power, diverting hard currency to import large quantities of a given staple, or

depositing money in the banking sector to prevent a credit crunch. The BRV maintains a 6 percent GDP growth rate target and a 11 percent inflation target for 2008.

Beyond 2008: The Model Breaks Down

¶9. (C) While high oil prices may prevent a full-blown crisis in 2008, we continue to believe that the BRV's economic model is unsustainable in the medium term. This model, which incorporates elements of populism and statism, has delivered four years of demand-driven growth. Its drivers are high government spending and a boom in private consumption, the former backed by the oil windfall and the latter fueled by government transfers, negative real interest rates, and currency controls. This model has deep vulnerabilities which go beyond proximate concerns of inflation and shortages and which are already beginning to express themselves.

¶10. (C) Perhaps the most damaging long-run consequence of the BRV's economic model will prove to be a significant decline in local productive capacity. Production in the oil sector, which in 2006 accounted for roughly one third of Venezuela's GDP at current prices, is already dropping thanks to mismanagement at PDVSA and reduced presence of multinationals (ref H). Productive capacity in many other industries may also be stagnating, as currency and price controls and government threats to seize private property have created severe disincentives to private investment. Official figures indicate that total investment is approximately 25 percent of GDP, and BRV officials use this figure to argue that current economic growth is sustainable. However the official figures do not differentiate between public and private investment. Everything we have heard suggests that private investment is low and concentrated in building sales and distribution networks rather than factories. As one businessman put it, "the country is drying out its productive roots."

¶11. (C) Other vulnerabilities stem from the consumption boom. Private consumption, particularly of imported goods, is increasing at an unsustainable rate, much of it financed by consumer debt. CADIVI authorized over 50 percent more foreign currency disbursements in 2007 than in 2006; the majority of these disbursements went to finance imports, which grew by 37 percent (from USD 32 billion in 2006 to USD

44 billion in 2007). Unless oil revenue keeps pace, over the next several years the BRV will be faced with an unpleasant choice between cutting back on import growth - with negative consequences for overall economic growth - and running down the hard currency reserves it has built.

¶12. (C) The financial sector has benefited tremendously from the BRV's currency controls and from four years of economic growth, and most traditional financial soundness indicators are relatively healthy. Yet most of our banking sector contacts believe that Venezuela's economic model is unsustainable, and that eventual problems will impact the sector. Several executives have pointed to the high percentage of consumption loans in banks' overall lending portfolio (estimated at 30 to 40 percent, with a substantial proportion unsecured) as a potential vulnerability. A slowdown in growth or tighter liquidity and credit conditions could lead to a rise in non-performing loans. In the past three months, the interbank lending rate has spiked twice and the average general lending rate rose six percentage points, from 18 percent in October to 24 percent in mid-January. These events were partly the result of BRV policies, including a large withdrawal of deposits from the private banking sector, but they also indicate a degree of fragility in a sector that has come to depend on liquidity growth and loose credit conditions.

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Wild Cards: Oil Prices,Production, and El Commandante
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¶13. (C) Gien the underlying vulnerabilities in the BRV's rtrograde economic model, we believe some form of eonomic crisis or major economic turmoil will occr in the next 12 to 30 months. The timing is heaily dependent on three unknowns: the future pric of oil, trends in Venezuela's oil production, ad BRV policy.

¶14. (C) In May 2007 we also foreast a 12 to 30 month timeline for such turmoil/cisis. There is one simple reason we have pushed he timeline back: the price of oil. The averageprice for the Venezuelan oil basket in 2006 was US 56 per barrel; in 2007 it was USD 65; and in th first week of 2008 it was USD 88. Assuming exprts of 1.8 million barrels per day, a back-of-theenvelope calculation suggests that the BRV earnsan extra USD 6.5 billion per year for each USD 1 increase in the average oil price. If prices sta at these historic levels, the BRV's fiscal and xternal positions will be strong enough to maintan the current economic model for several years, lbeit with increasing difficulty. A related varable, though not as volatile as the price of oil is Venezuela's level of production. As noted aove, production is falling, but we do not know how fast it is falling or where it might bottom out.

¶15. (C) The final unknown is BRV policy, which ests solely in the unpredictable hands of Presidnt Chavez. Had Chavez won the December 2 constiutional referendum and proceeded rapidly to consoidate power and further implement "21st Century ocialism" (ref I), we would expect economic probles (and, presumably, further political unrest) todevelop more quickly. Since the referendum's defeat, Chavez and his administration have sent contadictory messages about economic policy. In Decmber, Chavez took a confrontational tone and proised to keep the referendum's proposals alive (ref B). In his "Alo, Presidente" show January 6, however, Chavez acknowledged concerns about inflation and said he would "put the brakes" on his revolutionary program.

¶16. (C) The reality is that Chavez faces exceedingly difficult choices on economic policy. Given the oil windfall, there is likely still time for the BRV to make the policy changes that would turn an exceedingly hard landing into a much softer one. But these changes would require Chavez to loosen BRV control on the economy, reign in spending on his political agenda, and accept the political consequences of increased inflation and slower growth, all

actions that seem to go against his very nature. The alternative is to continue with the paternal statist/populist economic model for as long as oil prices permit and to repress the inevitable political dissent as the model's failures become increasingly apparent. Chavez' recent appointments of the former military officer Rafael Isea as Finance Minister and Haiman El Troudi, an orthodox marxist, as Minister of Planning (both with very limited economic experience; see ref A) suggest to us that the latter course is more likely.
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